Report to the State and Local Fiscal Modernization Commission:

Sales and Excise Tax Modernization Subcommittee

March 12, 2007

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Meetings:

12:00 noon – 1:30 pm, December 19, 2006
10:00 am – 1:10 pm, January 16, 2007
1:00 pm – 3:25 pm, February 19, 2007
12:00 noon – 2:15 pm, March 1, 2007

I. Subcommittee Charge

1. Determine appropriateness of the overall mix of revenue sources at the state level.
2. Determine whether changes in sales and use taxes, state excise taxes, and privilege license taxes are needed to align these taxes with general tax principles
3. Identify ways to broaden the sales tax base, lower tax rates, and eliminate special exemptions and rates, in order to align taxes with general tax principles.

II. Issues:

1. The subcommittee compared the proportions of state and local tax revenue collected from sales taxes in different states. In 2004, the proportion of North Carolina taxes

collected by its sales tax (about 23.5%) is slightly less than the national average (about 24.2%), and three of the other five mid-southeast states.[1]

2. The committee compared the number of services taxed by sales taxes. The median state taxes 55 of 168 services: North Carolina taxes 30.[2]

3. The committee discussed principles for tax modernization, namely equity, efficiency, sufficiency, competitiveness, and simplicity in administration and compliance

4. Committee members were asked to discuss their views on sales taxes, based on the principles enumerated above. The committee discussed whether its charge included determining tax rates, determining tax structure, or both. The point was made that the committee should focus on revenue neutral changes in tax structure. The statutory tax rates and the level of tax collections will be set by the States' political leaders, based on State needs.

5. It was suggested that North Carolina's differential sales tax rates may be inequitable. Differential rates make administration and compliance with sales taxes more difficult, but do not appear to have an economic justification. The committee discussed sales tax exemptions. The exemption for food for home consumption received special attention. Middle and upper income families benefit most by the food exemption. The food exemption narrows the base, and requires higher tax rates elsewhere, reducing competitiveness. A more efficient and equitable approach to aiding poor families would be to tax sales of food, and use some of the revenue collected to target benefits to poorer families.

6. North Carolina's sales tax is levied, primarily, on tangible goods: few services are taxed. A committee member asked if services should be included in the sales tax base. Not taxing services produces many adverse effects: i) it puts producers of tangible goods at a competitive disadvantage; ii) it produces a relatively light tax burden on households that consume disproportionate amounts of services; iii) it results in a sales tax base that is more variable over the business cycle; iv) it causes the sales tax base to erode, as spending shifts away from goods, toward services. Sales tax base erosion requires higher tax rates than otherwise would be the case. Taxing services would broaden the sales tax base, reducing base erosion. Therefore, a revenue neutral broadening of the sales tax to services would permit a decrease in the tax rate. A lower tax rate would tend to improve North Carolina's ability to compete. Some people and businesses may base location decisions, at least in part, on the level of tax rates. Broadening the base, and lowering rates, could improve North Carolina's attractiveness for such groups. Concern was expressed about how broad taxation of services should be. Should professional services (E.G., accounting, legal, and architectural services) be taxed? Most states do not tax

[1] Georgia, South Carolina, and Tennessee depend more than North Carolina on sales taxes. Kentucky and Virginia depend less than North Carolina on sales taxes.
[2] Federation of Tax Administrators' 2004 survey of sales tax on services.

them.[3] However, exempting some services can open the door for taxed service providers to argue their services also should be exempt. Therefore, political pressure to expand exemptions, and narrow the tax base, could be powerful, and are unlikely to observe tax principles. This point received a great deal of emphasis. Nevertheless, a concern was expressed that taxing medical services (E.G., dentists, doctors, nurses working outside hospitals, and medical labs) may not be viable or advisable.[4] On the other hand, rapid growth in medical services has contributed to sales tax base erosion. This is likely to continue, and could be worsened by retirement of the baby-boom generation. Excluding medical services narrows the base substantially. If equity is the reason for exempting medical services, an alternative would be financial support for medical spending for low income families. Excluding all medical services from sales taxation is an inefficient way to provide relief because it benefits many families who generally are not included in the group that needs relief. It may be best to tax all medical services, and target relief on poor families, as in Hawaii and New Mexico.

7. Karl Smith used the tax calculator to show how revenue growth and tax rates would be affected by the following revenue neutral changes in state and local sales tax structure:

a. broadening the sales tax base to include health services

b. broadening the sales tax base to include professional services

c. broadening the sales tax base to include entertainment

d. broadening the sales tax base to include food for home consumption

e. broadening the sales tax base to include all other exempted commodities

f. narrowing the sales tax base by excluding business-to-business transactions

g. broadening the sales tax base to include all other exempted commodities, all services, and food for home consumption

h. broadening the sales tax base to include all other exempted commodities, all services, food, but excluding business-to-business transactions

8. The committee compared state and local total tax revenues, and state and local sales tax rates. In 2004 North Carolina total tax revenue, as a proportion of personal income and in per capita terms, was less than the national average, but higher than in other mid-south states. The point was made that average tax rates, not marginal tax rates, probably are more important in location decisions. As well, comparing tax rates without comparing state services may not be informative, because the level of tax revenues tends to reflect citizens' demands for public services.[5]

[3] Hawaii's General Excise Tax and New Mexico's Gross Receipts Tax (sales taxes by other names) are levied on each service that the Federation of Tax Administrators includes in the category 'professional services.' South Dakota's sales tax is levied on most professional services.
[4] Hawaii's General Excise Tax and New Mexico's Gross Receipts Tax are levied on all medical services. No state taxes hospital services.
[5] Note that this point is consistent with a focus on revenue neutral reform of tax structure.

9. The committee discussed recent state tax reforms. Not many states have successfully extended sales taxes broadly to services. In 1987, Florida broadened its sales to many services, but the extension was repealed. At least one close observer of Florida's experience suggests the tax did not survive for political reasons. Nebraska broadened its sales tax to many services in 2002, and its attempt appears to have been successful.

10. The committee discussed North Carolina excise taxes. Excise taxes on wine, beer, and tobacco are levied per unit. The excise tax on gasoline is levied partly on a unit basis and partly on a percentage (ad valorem) basis. The excise tax on spirituous liquor is levied strictly in percentage terms. Real (that is, inflation-adjusted) tax collections from unit excise taxes are eroded by inflation, unless the General Assembly explicitly increases the per unit excise.[6] In contrast, the real value of both the sales tax and North Carolina excises levied in percent terms are automatically protected against inflation because the price of taxed commodities tends to rise with inflation.[7] The committee reached a consensus that a way should be found to prevent inflation-induced erosion in real tax collections.

11. The committee discussed the fact that beer, wine, spirituous liquor, and tobacco are taxed both by excises and by the general sales tax. For these commodities, North Carolina currently levies the general sales tax on the full retail sales price, which includes the excise tax (which is usually collected at the wholesale or distributor level). There was consensus that current practice should change: A mechanism for separating the excise tax from the retail sales price should be found, and the sales tax should be applied only on the latter.

12. Ten states apply both sales tax and excise tax on gasoline. The committee briefly discussed applying the general sales tax to motor fuel. Doing so would raise substantial revenue, and permit a substantial decrease in the sales tax rate. Sabra Faires, former Assistant Director, Department of Revenue, pointed out that it could be difficult to collect retail sales tax on gasoline because the incentive and the ability to avoid the tax would both be great. A sales tax on gasoline may be regressive, because lower income households probably spend a relatively high fraction of their incomes on gasoline. Also, a sales tax on gasoline could fall disproportionately heavily on rural households and businesses.

III. Speakers

1. At two meetings Karl Smith used the tax calculator to present estimates of sales tax revenue growth and tax rates. Karl demonstrated the effects of adding currently exempted or excluded sales transactions to the sales tax base. The Appendix presents

[6] For example, if the inflation rate averages 2.5% per year, after ten years a fixed per unit excise tax declines by about 22% in real, inflation-adjusted, terms.

[7] Anna Mitchell, Assistant Director of the Department of Revenue's Sales and Use Tax Division, pointed out that there is no clear reason for the different tax treatment of sales and some excise taxes. Staff made the conjecture that a partial explanation may be historical: when the earliest excises were imposed, it was difficult to calculate commodity taxes in percentage terms. This no longer is the case.

estimates of tax rates that would result if these transactions were included, and the level of sales tax revenue was maintained at current levels. The Appendix also presents some rough approximations to the difference between the expected growth rate of revenue and the expected growth rate of personal income in North Carolina, during the next twenty-four years, under different conditions. For example, given the current sales tax base, sales tax revenue will tend to grow an average of about 1.3% less than personal income each year for the next few decades. This occurs because currently taxed commodities tend to grow at a slower rate than the rest of the economy, and is indicative of erosion in the sales tax base. The Appendix shows that if health services were added to the sales tax base, revenue would tend to grow about 0.5% less than personal income: that is, the sales tax base would erode by less if health services were added to the sales tax base.[8]

2. Andy Sabol, Director of the Sales and Use Tax Division of the Department of Revenue outlined requirements of the Streamlined Sales and Use Tax Agreement, and answered questions. North Carolina is in full compliance with SSUTA.

3. Sabra Faires discussed her February 2003 memo to Secretary Tolson of the Department of Revenue. The memo included recommendations in response to the 2002 Governor's Commission to Modernize State Finance.

a. Sabra said many changes have been made in the sales tax, in response to SSUTA. Some differential rates and caps have been repealed. A 1% rate on certain transactions was repealed: these transactions are now taxed by the privilege license tax.[9] However, most exemptions listed in Sabra's 2003 memo remain, and new ones have been added: for example, there now is a special rate for modular homes. A $1,500 exemption for funeral expenses has been repealed: now tangible personal property sold by funeral homes is taxable, but funeral services remain exempt.

b. A Sales Tax Holiday has been created. Studies show tax holidays do not increase sales; instead, some sales are shifted to the period of the tax holiday, to avoid taxation. Thus, net tax collections tend to decline. However, retailers tend to raise prices during tax holidays, so the main benefit appears to accrue to retailers rather than consumers.

c. Broadening of the sales tax may usefully be thought of as taking place in three steps:

i) extend the tax to currently exempt tangible personal property.

ii) extend the tax to currently excluded services that are related to the purchase of tangible personal property, or are provided with the repair or maintenance of real personal property (E.G., tax lawn mower service, not

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[8] These illustrations are only rough approximations. Actual values will deviate from the estimates because of uncertainties in the model and unanticipated changes in the economy.

[9] These are coal, coke, and fuel oil used in manufacturing; manufacturing machinery and equipment; parts and accessories to manufacturing machinery; and manufacturing machinery purchased by contractors for use in the performance of contracts to construct manufacturing facilities.

just the spark plug installed when a lawn mower is serviced).

iii) tax additional services.

d. Sales taxes on some services are more difficult to implement than others because it is tricky to determine the source of the service. For example, it is easy to determine the source of a lawn service: it is the customer's location. But what is the source of a will sent to a client's residence through the mail? Is it the lawyer's office, or the residence? Accounting, advertising, and legal services present the most difficult sourcing issues.

e. Exempting food is administratively difficult, because subtle distinctions must be made.

IV. Concepts Brought Forward for the Commission's Consideration:

1. This section describes concepts the Subcommittee has agreed to bring forward for consideration by the full Commission. A brief introduction provides the general rationale or the concepts.

2. North Carolina's sales tax is levied primarily on tangible goods. Since North Carolina introduced its general sales tax, spending has shifted from goods to services.[10] As a result, over time, the sales tax base tends to decline as a fraction of personal income and as a fraction of government services. This erosion of the sales tax base is likely to continue. Therefore, the sales tax does not satisfy the principle of sufficiency. The narrowing tax base requires higher tax rates, which are inefficient and uncompetitive. Because the sales tax is narrowly focused on personal property, it discriminates against manufacturing, and against households that rely disproportionately on goods (that is, poorer households), which is inequitable. Spending on services tends to be more stable than spending on tangible goods, so excluding services makes the sales tax base less stable over the business cycle. The food exemption makes matters worse: careful research has shown that exempting food makes the tax less stable.[11] Including food would increase sales tax stability. Broadening the sales tax base to include food (and compensating low income households for the food tax) and services probably is the only tax reform capable of improving sufficiency, equity, efficiency, and stability. However, some difficulties lie in administration and compliance.

3. If the sales tax base in broadened to include services, revenue held constant, this will enable North Carolina to enjoy a substantially lower sales tax rate and provide the opportunity for the State to better balance revenue among sales tax and the personal

[10] When the sales tax was introduced in 1932, about 68% of household consumption spending consisted in tangible personal property, with the remainder consisting of services. Spending on goods has gradually declined to about 41% of household consumption spending.

[11] Unlike food spending, spending on non-food manufactured goods, such as appliances and consumer electronics, varies substantially over the business cycle. Therefore, state sales tax bases that exclude food are less stabile, over the business cycle, than state sales tax bases that include food.

income tax. This approach could also allow the State to consider eliminating the corporate income tax.

4. In light of these observations, the Subcommittee has agreed upon the following concepts:

a. North Carolina should broaden the sales tax base to include services, in a revenue neutral manner, and lower the sales tax rate. Base-broadening should take into consideration principles of equity, efficiency, and competitiveness, and should be accomplished in the simplest feasible manner consistent with these principles.

b. North Carolina should not exempt services from the sales tax base. The committee is mindful of difficulties in implementing this concept. Significant implementation issues, yet to be examined, must be addressed. A transition period may be required. Additional time is required to undertake this work

c. North Carolina should eliminate differential rates in the sales tax as well as sales tax exemptions. The committee supports elimination of the state food exemption, and the ½% local food exemption, but only under the condition that a mechanism is provided that would relieve lower income households from any additional tax burden.

d. North Carolina should move all excise taxes to an ad valorem methodology. In making this change the state may wish to consider not including the excise tax in the price of goods to which any sales tax is applied.

e. North Carolina should consider including privilege taxes as sales/use taxes or eliminate them all together since there are so few.

V. Issues yet to be reviewed and plan going forward:

1. The Subcommittee has tentatively agreed on the concept that North Carolina's general sales and use tax should be broadened to cover services, in a revenue neutral manner, so that the sales tax rate can be reduced. However, the Subcommittee is not yet prepared to forward concepts or recommendations about which types of services should be taxed, or how base broadening should be implemented.

2. The intangible nature of services tends to complicate implementation of a sales tax on services. Therefore, services are more difficult, than tangible goods, to tax. For example, sales taxes on accounting, financial and legal services can be difficult to source. Suppose a North Carolina law firm with offices in many states purchases accounting or financial services from a firm in Atlanta, to be used in all its law offices. It is not easy to determine where the services are performed or where they are used.

3. Further, the Federation of Tax Administrators enumerates one-hundred and sixty-eight different services, under seven general headings.[12] Administrative, compliance, implementation, and situsing issues all may vary, depending on the particular service. For example, professional services are difficult to source. In contrast, many personal services, such as lawn service, are easy to locate. However, personal services often are provided by very small firms. It is unclear whether the revenue that would be produced by taxing such services will exceed administrative costs. In order to broaden the sales tax in a sound way, and in accord with general tax principles, each of these issues for each type of service will require detailed study.

4. For these reasons, much additional work is required before the Subcommittee can agree on specific recommendations, and plans for their implementation. It appears unlikely this work will be completed by the planned Commission meeting in April or even this spring.

[12] The general headings are: Admissions and Amusements; Business Services; Computer Services; Fabrication, Installation, and Repair; Personal Services; Professional Services; Utilities; and Other Services.

APPENDIX

This appendix reports estimated tax rates that could result from including additional types of spending in North Carolina's sales tax base. The estimates are produced by the Institute of Emerging Issues' tax calculator. Also reported are very rough approximations of expected growth effects. The expected growth effects are derived from tax calculator estimates and are intended only as illustrations. They may be inaccurate due to uncertainty in the derivations and unanticipated changes in the economy.

I) Expected Growth and Tax Rates Given the Current Sales Tax Base:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 1.3%/year	**27%**	**4.25%**	**2.50%**

II) Expected Growth and Tax Rates if Additional Types of Spending are Included in the Tax Base (revenue constant at current levels):

Health services:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 0.5%/year	**35%**	**3.13%**	**2.00%**

Professional services:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 1.0%/year	**30%**	**3.75%**	**2.38%**

Entertainment services:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 1.0%/year	**32%**	**3.50%**	**2.13%**

Groceries:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 1.3%/year	**32%**	**3.50%**	**2.50%**

Construction/rental services:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 0.2%/year	**59%**	**1.88%**	**1.25%**

All other exemptions:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
- 0.8%/year	**46%**	**2.38%**	**1.50%**

All services, groceries, and all other exemptions:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
+ 0.2%/year	**99%**	**1.13%**	**0.88%**

All services, groceries, all other exemptions, excluding Business-to-Business Transactions:

Revenue Growth – Income Growth	Spending Taxed	State Rate needed for Current Revenue	Local Rate needed for Current Revenue
+ 0.2%/year	**61%**	**1.75%**	**1.25%**